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Understanding The Impact Of Financial Decisions On Financial Statements: A Pedagogical Note

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Viable financial planning requires financial managers' understanding of the consequences of impending decisions on their company's financial performance and position. Understanding the impact of prior decisions on their financial statements also enables future decisions aimed at improving their shareholders' wealth. This note intends to contribute to developing this capacity in finance students. We provide a presentation format directly connecting financial decisions to financial statement impacts. Bridging material covered in accounting courses and a finance student's needs as a possible future manager or analyst, this classroom pedagogy supplements and reinforces the objectives of the financial planning component of a finance course.

INTRODUCTION

The beginning finance student is often unable to link the knowledge gained in accounting courses to financial decision-making. Recognizing this phenomenon, many business schools have introduced a separate intermediate accounting course for finance majors with a primary objective of providing this needed understanding. This note provides a possible bridge to enhancing students' understanding of the impact of business decisions on financial performance and position, represented in traditional accounting statements. The proposed pedagogy benefits the objectives of either the finance-based intermediate accounting course or the financial planning module of a basic or intermediate corporate finance course. This pertinent knowledge enables students to use financial planning to better assess the consequences, desirability, and pitfalls of impending financial decisions, as well as evaluating the impact of previous financial decisions.

As anecdotal examples of students' faulty perceptions, many seasoned instructors of finance have experienced student statements like: "How can you say that this company

doesn't have the funds to invest in a new project? The balance sheet shows that we have \$1 billion of retained earnings. Why doesn't this firm have any cash; it had a huge net profit last year?" In each case, the questioner fails to understand the financial consequences of the knowledge gained from accounting. The student may recognize the decision's impact on specific accounts and the mechanics of deriving the financial statements, but lacks the ability to interpret the financial significance of the decision. As educators, it is our responsibility to provide students with an ability to critically analyze the financial implications of their decisions and recognize these consequences through the impact on the financial statements.

By integrating their financial and accounting knowledge, the pedagogical exercise aids students in analyzing pro forma and actual financial statements, including the balance sheet and the income statement. Viewing transactions based only on accounting identities does not allow the student to readily understand the full consequences of particular decisions. The forwarded pedagogy in this note provides a direct linkage among the financial decision, the accounting mechanics, the financial statements (balance sheet and income statement) impacts, and the effects and consequences to the company's financial performance and financial position. The student is able to assess previous decisions and make appropriate future decisions.

XYZ CORPORATION'S ENVIRONMENT

Table 1 contains the set of decisions directly affecting the financial position and performance of XYZ for the month of January of the current year. The objective of the exercise is to have the number of decisions and the resulting required transactions sufficiently large enough to demonstrate the financial impacts arising from prior decisions, financial decisions required for current operations, and investment decisions needed for future operations. Yet, inclusion of too many transactions diverts the students' focus from the primary objective. The objective is to highlight the importance of their individual decisions, and demonstrate how their decisions shape the financial performance and position of their company. The first three transactions in Table 1 arise from prior operations, while transactions four through nine are from current operating decisions, while the last transaction is for an investment in inventory needed for future operating periods.

With respect to decisions related to current operations, the intent is to demonstrate to the students the types of decisions that impact current operating performance, why they are necessary, and how they impact company performance. The students then can see the clear linkage of their decisions to the resulting income statement performance. We will demonstrate this linkage through the discussion of the specific decisions while also showing each decision's effect on the firm's financial position, which is represented by simultaneous changes in the balance sheet.

Table 1. One Month of Company Transactions

\$40,000 in cash is collected from Accounts Receivable.

\$55,000 of the Accounts Payable is due this month and is paid in cash.

The mortgage payment of \$2,027, which includes a monthly interest rate of 12% APR, is paid in cash. The principal payment is \$493 and the interest expense is \$1,534.

The company has \$80,000 in sales revenue: \$50,000 is in credit sales and is included in the Accounts Receivable, and the remaining \$30,000 of sales are for cash.

The cost of goods sold required to generate the Transaction 4 sales is \$50,000. The goods are sold out of inventory.

Selling and Administrative expenses are \$13,000 and are paid in cash.

The plant is depreciated by \$875 and the equipment is depreciated by \$417.

The tax rate is 40% and is accumulated in the Taxes Payable Account and paid on the first quarter tax due date of April 15th.

Pay \$.25 dividend to shareholders (20,000 shares outstanding) in cash.

The minimum inventory investment level to satisfy safety stock requirements is \$30,000. Given an initial inventory of \$70,000 and sales out of inventory of \$50,000, a \$10,000 inventory replenishment is needed. The suppliers grant us credit for 60 days, thereby, the Accounts Payable will increase by the \$10,000.

THE STARTING BALANCE SHEET POSITION

The starting balance sheet for January, which provides the initial and start-of-month financial position of the company, comes from December the 31st of the prior year. The second column of Table 2 contains this start-of-month balance sheet for XYZ.

Given a basic accounting class, most students recognize that the column 2 Table 2 balance sheet represents the financial position, or "snapshot," of the firm at a given point in time. Students need to recognize that the balance sheet represents the starting financial position of the XYZ Company. This includes the investments previously made in the various assets in column 2 of Table 2, and the sources of capital provided by investors in the form of liabilities and equity. An understanding of the company's financial position, represented in column 2 at the beginning of the period, can be achieved with a case approach; the instructor asks questions and draws out discussion from the students. Alternatively, if sufficient time is not available for a case approach, a

Table 2. Financial Decisions' Impact on Financial Performance and Position: A Pedagogical Exercise

Column	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	
Transaction Description	Prior transactions impacts			Current operations			Future needs			Change	Balance	Change	Balance	Change	Balance	Change	Balance	Change	Balance	Change
	1	2	3	4	5	6	7	8	9											
Account Balance or Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change
Balance Sheet Effects																				
ASSETS																				
<i>Cash</i>																				
<i>Accounts Receivable</i>																				
<i>Inventory</i>																				
Fixed Assets:																				
<i>Plant</i>																				
<i>Acc. Depreciation</i>																				
<i>Equipment</i>																				
<i>Acc. Depreciation</i>																				
<i>Net Fixed Assets</i>																				
Total Assets																				
LIABILITIES & EQUITY																				
Current Liabilities:																				
<i>Accounts Payable</i>																				
<i>Notes Payable</i>																				
Total Current Liabilities																				
Long-term Liabilities:																				
<i>Mortgage</i>																				
Total Liabilities																				
Equity:																				
<i>Stock (\$1 Par)</i>																				
<i>Retained Earnings</i>																				
Total Equity																				
Total Liabilities & Equity																				
Balance Sheet Inventory																				

Transaction Description	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	
Account Balance or Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change	Change
Income Statement Effects																				
Revenues																				
<i>Cost of Goods Sold</i>																				
<i>Selling and Administrative Expense</i>																				
Depreciation (Plans)																				
Depreciation (Equipment)																				
Earnings Before Interest and Taxes																				
Interest Expense																				
Earnings Before Taxes (EBT)																				
Taxes (40% Rate)																				
Earnings After Taxes (EAT)																				
Dividends																				
Transferred to Retained Earnings																				

lecture can establish the required student understanding of the contents of a balance sheet, income statement, and their relevance to financial management.

FINANCIAL DECISIONS AND RESULTING STATEMENT IMPACTS

Next, we examine management's financial decisions and their direct impact on the company's financial performance through changes occurring in the income statement and the simultaneous effects on financial position through induced balance sheet changes. Given the starting position with the balance sheet in column 2 and the blank starting income statement, also in column 2, the impact of each of the ten transactions on either or both statements is contained in columns to the right of column 2. With the transactions that follow, a student's knowledge is repeatedly reinforced since with each transaction the balance sheet must have assets equal to liabilities plus equity. This is demonstrated clearly in each transaction column that will be shown in Table 2. The teacher must be vigilant in making the student understand that the balance sheet remains in balance with every transaction. If this algorithm on maintaining the debit and credit parity is lost it is often very difficult to discover why a balance sheet does not balance or cannot be reconciled with the income statement.

Prior Decisions' Impacts on Position and Performance

The impact of the first three transactions from Table 1 is presented in columns 3 through 5 of Table 2. The three prior-period decisions impact the current company's financial position during January because they induce current changes in the balance sheet. The instructor should go through the impacts of each transaction column by either class discussion or lecture.

The Prior Transactions' Impacts section of Table 2 contains three transactions, including the collection of revenues of prior sales from Accounts Receivable, paying Accounts Payable, and paying the Mortgage principal. Accounts Receivable contributes \$40,000 to an increase in XYZ's Cash account in column 3. Offsetting this increase, payments reducing Accounts Payable require a \$55,000 reduction in cash in column 4 and the principal payment on the Mortgage in column 5 cause another \$493 reduction in the Cash account. These operations and obligations lead to a reduction in the firm's cash of \$15,493 from the opening balance in column 2 to the trial balance in column 6.

This is an appropriate time through discussion or lecture to make the point that the three transactions just covered, which affect the Balance Sheet (including assets, liabilities, and equity), do not have any impact on the Income Statement (presented below the Balance Sheet information in Table 2). Thus, the payment of debt principal requires cash, but is not considered an expense on the income statement. However, interest payments are deducted before taxes and consequently they are included in the income statement. Transactions 3 and 8 in column 11 of Table 2 reflect the impact of

interest expense and taxes on the income statement. In sum, the Prior Transactions' Impacts section of Table 2 demonstrates that a considerable reduction in cash resulted from earlier period decisions.

Students usually have not considered the linkage between financial decisions and their later consequence on financial statements and their company's financial position. Given this condition, this might be an appropriate time to discuss the possible negative consequences of excessive current financial or operating leverage decisions on the firm's future financial position and performance. Numerous real-world examples during the recent 2000 through 2003 economic pull-back may be mentioned to demonstrate that actual managers may have been guilty of poor planning, or hubris, with respect to believing that a poor economic environment would not so negatively affect their company's position and performance. You can then indicate that with appropriate scenario analysis they may have had better prior decisions and not been so adversely affected by extremely poor performance, and sometimes failure. The objective is to establish a connection between current financial decisions and the possible impact of these decisions on the future position of the firm. This provides a valuable exercise in better understanding the impact of financial decisions. This insight is not found in most accounting courses, where the focus is on the recording of each transaction and the mechanical process of creating the end-of-period financial statements. Discussion of the decisions that result in the accounting transaction and the future consequence of the decision are rarely addressed. Establishing this connection is critical in having students understand the purpose underlying financial planning, including what-if planning, flexible budgeting, and scenario analysis.

Current Operating Conditions' Impacts on Position and Performance

The impacts from the current month's operating decisions, which have both income statement and balance sheet effects, are shown in columns 7 through 12 of Table 2. As before, the instructor can go through the impacts of each transaction column by either class discussion or lecture. Each of the included transactions (numbered 4 through 9 in Table 1) is now briefly reviewed.

From transaction 4 of Table 1, the firm records \$80,000 in Revenues in column 7 of Table 2 during the current month. Of this amount, \$30,000 is received in cash while the remaining \$50,000 is sold to customers on credit and is reflected in an increase in the firm's Accounts Receivable line of Table 2. The impact on the income statement is recognized with \$80,000 on the Revenue line and the offsetting Taxes line marginal tax consequence of an additional \$32,000 tax liability. This net income statement effect of \$48,000 ($\$80,000 - \$32,000$) is the net income after tax effect arising exclusively from this transaction, that is, without considering the costs required in obtaining the revenues. The students can then see that this net effect of \$48,000 results in an identical size increase of the Retained Earnings line of the balance sheet of the company.

An important lesson can be provided to students from the income statement section and the Retained Earnings line from the balance sheet section of Table 2. Each Current Operation transaction from the income statement affects a number of accounts, but always affects the retained earnings account by the transaction's net change in Earnings-After-Taxes. Companies today with internal computerized accounting systems have the capability of generating statements at any given point of time; if desired, this could be done transaction by transaction. The Table 2 format can also be used to accomplish this task, and is discussed later in more detail.

An advantage of the Table 2 approach comes from not having to go through the accounting requirements of closing out the income statement at the end of the period to find the increase in retained earnings. Also, the standard practice-set approach used in accounting courses generally disconnects the initial decision, the transaction, and the resulting impact on financial statements. In the accounting set environment large numbers of transactions are recorded separately to accounts one entry at a time. Next, at the end of the journal entry phase, the results of numerous transactions are reflected in a given line account. These are then used to create the income statement, which in-turn is closed out with the Earnings-After-Taxes being closed to the Retained Earnings account on the balance sheet. In this environment, most students do not recognize the connection between the original decision and the resulting impact on the financial condition of the company. Table 2 helps clarify this connection.

The remaining transactions, 3 and 5 through 9 from Table 1 are in the Current Operations section of Table 2. Not covered in detail here, the logic and objectives in learning noted above can be reinforced by having students understand the impacts of various decisions and types of transactions. We have included a cost transaction in column 8 of Table 2 requiring the expensing of a current asset, inventory, and a selling and administrative expense transaction in column 9 requiring a cash payment. The depreciation charge in column 10 reflects the expiration of the service potential of fixed assets that are expensed during the month. It is worthwhile having students recognize that this transformation of an asset to operating benefits enables business continuance and revenue generation. This is also an appropriate point in the presentation to indicate that the investment in the asset occurred and required the cash flow in an earlier period. Thereby, the depreciation write-off only has an indirect cash flow effect in the current period because of the reduction in taxes coming from now recognizing this non-cash flow expense. The interest expense coming from the mortgage payment is covered in column 11 while the principal component of the total payment was reflected in column 5, covered previously. The dividend payment in column 9 reduces the Retained Earnings account line and is a distribution after Earnings-After-Taxes in the income statement section.

With the observed column changes by each transaction in the balance sheet and income statement, students are easily able to recognize how each of the financial decisions contribute to changes in the firm's final financial position and performance.

The operating decisions help students appreciate that the income statement represents an accumulation of transactions over a given time period that are directly related to the period's operating needs and the operating performance of the company.

As an in-class and/or homework exercise, the instructor can have students determine the balance sheet position and income statement performance position at the end of any of the transactions in columns 7 through 11. This reinforces student recognition that each transaction leads to a changed balance sheet and/or income statement. Trial balance sheets and income statements are provided in columns 6 and 13 to demonstrate the transformation of the starting position of December 31 occurring due to the intervening transactions.

Current Decisions Desired to Meet Future Needs

Column 14 contains the transaction coming from the financial decision to invest in inventory to provide a sufficient safety stock to meet anticipated future operational needs. The Inventory line of the balance sheet increases by \$10,000, which is purchased for future sales using credit represented in an increase in the Accounts Payable line. There are no current cash flow consequences. The cash outflow will occur in the future when the firm reduces the accounts payable incurred due to the inventory purchase. Since this represents an acquisition of an asset and results in no current period revenues or expenses, only the end-of-month balance sheet position is effected. It is worth noting to the students that this decision will have an impact in a future period. In the future, the accounts payable will have to be paid, resulting in a cash outflow. Additionally, inventory will be expensed as it is sold, hopefully generating sufficient revenues to provide investors an adequate rate of return for their investment in the XYZ Company.

Additional Possible Exercises and the Excel Spreadsheet

An Excel spreadsheet very similar to the one shown in Table 2 can be downloaded by going to the following web site: <http://bsob.jcu.edu/ECFN/Dr.%20LeRoy%20Brooks.htm>. The spreadsheet is like Table 2 except that an extra blank column occurs between columns 5 to 6, 12 to 13, and 14 to 15. This allows entry of any of the three types of transactions we have presented by either the instructor or students. If you have computer projection capability, this is useful for classroom exercises where the immediate impact of a transaction on the balance sheet and income statement can be derived. Non-balancing balance sheets and incomplete transactions are common and their existence and resolution help reinforce the need to understand the consequences of financial decisions. There are extra rows in the template from Table 2. Row 42 of the template spreadsheet shows the statement, "Balanced," when the balance sheet entry balances and "NOT BALANCED!" when it does not balance.

As an exercise, the class can consider the impact of purchasing a capital budgeting

project at the end of the period. This would be a "Future Needs" type of transaction and would be entered in the new column between the current Table 2 columns 14 and 15. If a cash purchase, the Cash balance would decrease by the equipment cost and the Equipment account would increase by the equipment cost. The objective of any developed exercise will be to make them reasonably straightforward and simple. Otherwise, too much time would be required in presentation, usually with a requisite increase in student confusion. For example, having the project above purchased and used from the beginning of the period would likely require a column 7 Revenue impact, column 8 cost impact, column 10 depreciation impact and a required entry recognizing the purchase of the equipment. If it were purchased with a loan more entries would be required.

END-OF-PERIOD FINANCIAL PERFORMANCE AND POSITION

The Monthly Income Statement and Closing Balance Sheet

The impact of all of the current operating transactions determine the income statement for January 1st through January 31st and together with the past transactions, determine the balance sheet at January 31st, both presented in column 15 of Table 2. XYZ had a profitable month with a monthly net income is \$8,504. This enabled XYZ to pay \$5,000 in dividends to shareholders and still increase retained earnings by \$3,504 for the month of January. The balance sheet total Assets and total Liabilities & Equity both decrease by \$36,319 from the prior December 31st balance. These changes can be primarily attributed to reductions in inventory and accounts payable, respectively.

The instructor now has the opportunity to use discussion or a lecture to enable students to see how the income statement only represents current operations and, by itself, does not account for all of the business activity during the period. Decisions and operations from the past, present, and future apply when considering all of the transactions of a given period, as demonstrated in the three types of transactions shown in Table 2.

Students should also be made to understand that the information on the XYZ Company in the example is still insufficient to make judgments about the company's performance over time or relative to its industry sector. The discussion can be framed by asking what additional information would be needed to analyze the competitiveness of XYZ's financial position and performance.

It is reasonable to have the students discuss possible performance measures that would be used for evaluation. The month's return on equity and return on investment can be derived. The numbers can also be annualized for comparability with generally published information on these ratios. Shortcomings inherent in the specific performance measures based on one month of operation can also be discussed. The objective is to provide students with the ability to analyze performance based on the

initial financial decisions and to determine how these decisions emerge in the resulting transactions and financial statements. It is worthwhile highlighting that this analysis process can be with respect to either pro forma financial planning of proposed decisions or ex-post analysis of the results arising from prior decisions.

Cash Flow Changes and the Sources-and-Uses Statement

The change in the cash balance from December 31 to January 31 can also be observed by scanning the Table 2 Cash account line in the Current Assets section of the balance sheet. The set of transactions on the Cash account line provides an overview of the actual cash flows for the period that would be shown in a Cash Flow statement. This would be the time to clarify to students that a Cash Flow statement shows all sources of actual cash inflows and outflows, where the difference from the starting date cash balance to the closing date cash balance is always the change in balance. This is confirmed on the Cash account line of the balance sheet where the starting balance of \$36,000 on December 31 of the prior year decreases by \$5,027 to \$30,973 by January 31 of the current year. This decrease occurs despite the company's "profitable" month of operations as judged by the Earnings-After-Taxes on the income statement in column 15 of Table 2. This provides the instructor with the opportunity to establish the points: (1) profitability does not necessarily indicate maintenance of liquidity, and (2) accounting income generally does not equate to economic income. The income statement provides the accrual based accounting income while the Cash Flow statement provides the measure of economic income inflows and outflows.

As an additional exercise it is useful to provide students with Table 3, the Sources-and-Uses-of-Cash statement. The differences between the Cash Flow statement, represented by the Cash Account line of Table 2, should be compared with Table 3 to see how they differ, even though they have the same answer. In our case, a cash change from \$36,000 on December 31 of the prior year to \$30,973 by January 31, representing a decrease of \$5,027. The point should also be made that the Sources-and-Uses-of-Cash statement includes *Earnings-After-Taxes*, which is an accrual accounting measure and not a cash flow measure. Therefore, the Sources-and-Uses-of-Cash statement needs to correct for non-cash flow items that were used in the determination of Earnings-After-Taxes. Thus, depreciation, a non-cash flow item, needs to be added to Earnings-After-Taxes to derive the actual net cash flow. The Cash Flow statement does not need this adjustment since it only includes actual cash transactions. This exercise reinforces the use of accounting income in determining net income and the use of cash flows in determining economic income. The exposure of these concepts here is then reinforced when instructors get to capital budgeting exercises later in the course. Then depreciation must be considered in the income statement in determining the cash flow for taxes. Using the income statement approach, depreciation (a non-cash flow expense accrual income prior deduction) must then be added back to net-income-after-taxes in getting

Table 3. Sources-and-Uses-of-Cash Statement

<i>Operating Activities:</i>	
EAT:	\$8,505
Depreciation (Plant and Equipment):	\$1,292
Deferred Taxes:	\$5,670
Account Receivable:	(\$10,000)
Inventory:	\$40,000
Accounts Payable:	(\$45,000)
Total from Operating Activities:	\$466
<i>Investing Activities: (Not applicable in this case example)</i>	
<i>Financing Activities:</i>	
Mortgage Repayment:	(\$493)
Dividends:	(\$5,000)
Total from Financing Activities:	(\$5,493)
<i>Effect on the Cash Account:</i>	
Cash Account (Beginning of Period):	\$36,000
Change in Cash Account:	(\$5,027)
Cash Account End of Period:	\$30,973

*The Change in Cash Account is the sum of the effects from operating activities, investing activities, and financing activities. This presentation is similar to Helfert's [2000] Statement of Cash Flows

the economic income required in making capital budgeting decisions.

Also, the instructor can have the student compare the Cash line of Table 2 with the Retained Earnings line to enable students to realize that retained earnings is not a "sack full of cash." The increase (or decrease) in the retained earnings account measures the change in the shareholders' claims on the firm's assets resulting from the accounting objective of appropriately matching expenses to revenues. This includes both cash and non-cash transactions, which can be examined on the Retained Earnings row in columns 7 through 12 of Table 2. Alternatively, the Cash line demonstrates that the ending cash position in Table 2 comes from the initial cash balance and the numerous transactions providing or requiring cash over the month.

SUMMARY AND CONCLUSION

By examining the connection among decisions, resulting transactions, and the impacts on both the income statement and balance sheet, the Table 2 presentation

captures numerous aspects of financial statement planning and analysis in a clear fashion. Students readily see how the transactions of a given period reflect business decisions and operations from the past, present, and future. The Table 2 presentation approach captures the transformation of the decisions to transactions and then to understandable consequences on a firm's financial condition by showing:

- The financial performance of the company that is represented in the income statement section of Table 2;
- The financial position of the company that is represented in the balance sheet section of Table 2; and
- The company's liquidity position, which is reflected in the Table 3 Sources-and-Uses-of-Cash Statement, which is also captured by the economic income effects covered in the Cash account line of the balance sheet of Table 2.

This self-contained relational model aids students' understanding of the financial manager's use of pro forma statements for financial planning and financial management, or an external analyst's evaluation of prior or expected company performance.

The traditional accounting set approach of using T-accounts, journal entries and separated statements of income, balance sheet, cash flow, and sources-and-uses-of-cash provides a weaker pedagogical approach in enabling an understanding of the consequences of financial decisions on a firm's financial standing. For example, a T-account representation of the period's operations does not allow one to see how the transactions in one account affect another account or how they directly affect the income statement and balance sheet. A journal entry at least demonstrates the effect of a transaction on at least two accounts, but again fails to demonstrate the integration observed with the Table 2 approach. Each of the separate financial statements provide valuable information on the company's performance or position or liquidity, but fail to show the relationships among the statements, which is also demonstrated in the Table 2 approach.

We believe the suggested presentation approach of the XYZ case to be appropriate for use in the financial analysis and financial planning modules of a core finance course. Its use would also be well suited for an intermediate accounting course designed for finance majors.

ENDNOTES

The authors thank Rob Lippert for helpful comments.

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